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TAXATION OF OVERSEAS ALLOWANCES: INTERESTED AGENCY VIEWS

The Inter-Agency Committee on Allowances and Benefits is currently reviewing the existing structure of federal civilian overseas allowances and benefits to arrive at recommendations on a comprehensive allowance program to effectively and equitably meet current U.S. Government requirements for overseas operations. Since the treatment of allowances for tax purposes has long been an essential element of the entire allowance structure, the Committee members were invited to submit their comments on draft legislation developed by the House Ways and Means Committee in 1974 which would repeal Section 912 of the Internal Revenue Code, under which certain allowances have traditionally been exempt from taxation.

Most of the agencies which responded--including those with the overwhelming majority of overseas employees--strongly opposed repeal of Section 912 for a wide variety of reasons including the non-income nature of allowances, increased administrative costs, the impracticality of equitably augmenting allowances to offset taxation, the unfavorable effect on the size of the Federal budget and, therefore, on inflation, the unlikelihood of real net additional revenues to the U.S. Government, and adverse impact on the ability of the Government to attract and retain overseas employees.

The Treasury Department submitted a memorandum supporting repeal of Section 912 for a number of reasons, most of which were related to the avowed need of maintaining internal consistency among taxpayers be they Government employees or not. Two or three agencies who either have very limited overseas operations or have only recently begun to assign employees overseas found the Treasury position persuasive.

Most agencies responding, however, found the Treasury memorandum unconvincing in arguing the necessity for strict equality in the tax treatment of Government and non-Government civilian overseas allowances, particularly in view of the inequality which has existed for almost half a century in the treatment of basic salaries as between Government and private employees resident overseas for extended periods (in excess of 17/18 months) and in attempting to minimize the inequality which would continue to exist, following the repeal of Section 912, between the treatment of such allowances as military and Government civilian overseas housing allowances, which are, after all, very similar in nature. Most agencies found that the Treasury memorandum tended to play down the non-income nature of allowances, under-estimate the difficulties in constructing and administering any equitable alternative to the tax-exempt status of overseas allowances, over-estimate the contribution--if any-- which repeal of Section 912 would make to the equity and progressivity of the tax system, and totally ignore the unfavorable inflationary impact which repeal of Section 912 together with offsetting additional allowances--the course suggested by the Treasury--would have on the size of the Federal budget.

Finally, Treasury introduced an illusory concept in its memorandum by suggesting that repeal of Section 912 would provide a better picture of the true costs of Foreign operations. The only costs which would be illuminated by repeal, under the scenario suggested in the Treasury memorandum, would be the artifical costs to the Government of paying additional allowances to permit employees to pay offsetting taxes back to the Government. The only real costs--net costs to the Government--would be the administrative cost of maintaining this unproductive circular flow of funds--a cost which should not properly be associated with "foreign operations." This assumption is based on the very questionable issue of all agencies being able to secure appropriations to offset the tax being paid by employees.

Background of Repeal Initiative - Many respondants found the history of the current repeal initiative, as presented in the Treasury Department memorandum, very illuminating. For nearly half a century--since 1926--private citizens resident outside the United States for 17 out of 18 months or longer have enjoyed a $20,000 or $25,000 exclusion from gross income in computing their federal income tax liability, and it was an attempt to eliminate this "loophole" which led to the initiative also to eliminate the exclusion of allowances paid to overseas Government employees. But Government overseas employees have never enjoyed the blanket gross income exclusion enjoyed by private citizens resident overseas. And the exclusion of allowances, which is dismissed in the Treasury memorandum as a "wartime necessity," is actually much more than that: it is a recognition that the excluded allowances are essentially not increments to the incomes of Government employees stationed overseas, but that they are essentially reimbursements for job-related expenses.

Salary Increments vs. Reimbursements

The Treasury Department memorandum neglects to point out that tax law has long distinguished between those allowances which do represent increments to income (such as the "hardship differential") and those which are intended to offset expenses employees incur only by virture of their assignments overseas by the U.S. Government. (The latter include the "cost-of-living" or "post allowance," the housing allowance, and the educational allowance.) Increments to salary have traditionally been taxed. Reimbursements for extraordinary job-assignment-related expenses have not. The responses of most agencies reflected their belief that any revision of the tax treatment of allowances must continue to differentiate between those allowances which leave an employee financially "better-off" than had he not been assigned overseas, and which therefore do constitute increments to income which should properly be taxed, and those allowances which--regardless of their gross magnitude--leave the employee no "better-off" financially, or insignificantly better-off than had he continued to reside in the United States.

Cost-of-Living Differential (Post Allowance) - These allowances are, in theory, a clear example of reimbursements intended to offset the additional cost-of-living overseas, leaving the employee no worse, but also no better-off than had he remained in the United States. If they are properly established, they are therefore clearly not "income" and should not be taxed. If there are weaknesses in the methodology by which the allowances are set, the appropriate remedy is correction of the methodology, not taxation.

Educational Allowances - This is another case of reimbursement, which should not be taxed. If an employee were not assigned overseas, he would have the advantage of free public education for his children. When assigned overseas he must usually pay to educate his children, and is no better-off in net financial terms by virtue of an allowance which offsets these educational expenses. It is overly simplistic to argue that some federal employees may not pay state tax while overseas and that this possible saving offsets any educational costs. All U.S. Government employees including those serving overseas are subject to the laws of their state of residence in regard to State and Local Income Taxes and are subject to the same penalities as are all citizens of that state. Free public education is financed by federal and local property taxes as well as by state taxes, and is financed by taxes paid by taxpayers throughout their lives, not only while their children are attending public schools. Thus, even assuming that some few employees might not be required by the laws of their states of residence to pay state income taxes while abroad, the portion of this temporarily reduced tax liability which could appropriately be allocated as an offset to extraordinary educational expenses would be not only minimal, but also impossible to establish equitably.

Housing Allowances - The housing allowance is also, essentially, an offset against extraordinary housing expenses which an employee encounters as a direct result of his assignment in a foreign country.

Major components of the housing allowance (or of Government-supplied housing) are business-related expenses which leave the employee no better off financially than were he living in the United States and responsible for his own housing. Clearly an employee has not received an increment to income if he is required by his employer--the U.S. Government--to live in a "representational" dwelling so that, as part of his job he can entertain foreign nationals. Nor is an employee better-off financially by virtue of being required to live in a high-rent district in order to be near the Embassy for security reasons or for the convenience of the Government, or by virtue of being assigned to a country where rents are substantially higher than in the United States.

An argument can be made that an employee may be somewhat better-off financially than his counterpart in the United States since he does not pay the basic housing costs he would incur living in the U.S. Unfortunately, even this issue is not as clear-cut as it may appear. Employees owning homes in the United States who are assigned overseas are faced with what is all too often a "no-win" choice. Some sell their homes, thus incurring unreimbursable costs of sale, and depriving themselves of the tax benefit accorded mortgage payments. Since they cannot usually purchase new residences within the prescribed period, they also usually incur a capital-gains tax upon sale of their house, and they are denied the continued appreciation of property value they would have enjoyed had they retained their homes. As a result, upon return to the United States following a foreign assignment, they must pay substantially more for a comparable residence, in addition to purchase costs. In recent inflationary years an increasing number of employees have actually been financially unable to repurchase their prior residence.

Other employees choose to retain and attempt to rent their residences while abroad, but they, too incur substantial costs. Homes often stand vacant for long periods during which normal mortgage, tax and maintenance costs must be met. Most employees feel the need to pay for property management; many experience damage to their homes or extraordinary maintenance costs which they are unable to recover from their tenants. Housing allowances overseas actually helps reimburse some of these extraordinary, job-related expenses.

Moreover housing furnished employees at some posts is unavoidably below U.S. housing standards, so that it may be questionable how much "better-off" an employee is to be living in such a home "rent-free." Where there is government-owned or leased housing or where security conditions dictate an employee actually has little freedom of choice in determining the kind and location of the housing he occupies. Finally, it should be noted that housing allowances are not set sufficiently high to cover the expenses of all employees. Since allowances are based on average costs at posts, significant numbers of employees, particularly new arrivals at posts experiencing high rates of inflation, find themselves out-of-pocket for housing expenses. Accordingly, the housing allowance is one to which the inter-agency committee is devoting primary attention in an attempt to arrive at an equitable, uniform treatment of this concept.

The Inter-Agency Review and Tax Revision - The Inter-Agency Committee on Overseas Allowances and Benefits was convened, in part, in response to concerns raised by the GAO and others with inequities between federal agencies in the treatment of overseas allowances. The review currently under way should result in a federal foreign allowances program which is not only more uniform among participating agencies, but in which the true nature of each allowance--be it incentive increment to income or business expense reimbursement--will be clearer than at present. Accordingly, most agencies responding to the Treasury Memorandum on taxation of allowances do not deny that some change in the tax treatment of some allowances may be warranted. There is general agreement, however, that consideration of any change in the present tax treatment of allowances should await completion of the current-inter-agency review and that a flat repeal of Section 912 at this time would be grossly inequitable, prejudicial to the operations of the foreign affairs agencies, potentially inflationary, and without significant benefits to overall U.S. Government operations.

Repeal of Section 911 and Repeal of Section 912

Most responding agencies felt there was no logical necessity to link repeal of these two sections, particularly when it is realized that the allowances covered by Section 912 are essentially non-taxable reimbursements of job-related expenses. Section 912 serves to provide an efficient an economical means of recognizing the non-income nature of these allowances, as opposed to requiring each agency to report them and each employee to itemize the expenses in his return. Similarly, some respondants felt that allowing similar exclusions for private overseas employees would not--as the Treasury memorandum suggests--amount to Government subsidy, but only to recognition that the necessary expenses of doing business abroad are somewhat different--and greater--than in the United States. Indeed, the Inter-Agency review, when completed, may be useful to the Treasury in establishing what extraordinary business expenses are applicable to overseas operations and should be excluded by private as well as Government employees.

Attached are the responses of representative foreign affairs agencies, together with the Treasury Department memorandum on the proposed repeal of Section 911 and 912.

Attachments:
As stated